MCI Communications Corporation
1717 Pennsylvania Avenue, NW
Washington, DC 20006
1 202 721 2584
Fax 1 202 721 2799
e-mail: 2203886@mcimail.com

Kenneth A. Schagrin
Associate Counsel
International Regulatory Affairs
Law and Public Policy

ORIGINAL

July 20, 1998 EX PARTE OR LATE FILED

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
1919 M Street, NW
Washington, DC 20554

Re: *Ex parte presentation*
IB Docket No. 97-142

Dear Ms. Salas:

On Thursday, June 25, 1998, MCI, met with Donald K. Stockdale, Jr., Common Carrier Bureau and Douglas W. Webbink, Susan O'Connell, Adam Krinsky and Robert Calaff of the International Bureau about the issue of "grooming" of inbound international traffic raised by SBC Communications, Inc. in the above-captioned proceeding. The Staff requested a more detailed written presentation on the issue. Attached is that presentation.

Two copies of this letter are being filed with the Secretary of the Federal Communications Commission in accordance with Section 1.206(a) of the Commission's rules.

Sincerely,

Kenneth A. Schagrin

Cc: Susan O'Connell (International Bureau)
Adam Krinsky (International Bureau)
Donald K. Stockdale, Jr. (Common Carrier Bureau)
Douglas W. Webbink (International Bureau)
Robert Calaff (International Bureau)

Grooming of International Traffic Terminated In-Region by an ILEC

I. Grooming agreements: economic incentives

U.S. carriers may seek to enter into grooming relationships with foreign carriers to reduce their costs. Not every grooming relationship that lowers a U.S. carrier's costs, however, will be in the interest of the U.S. public:

Case 1: Grooming that increases economic efficiency

Grooming may allow a U.S. carrier to realize operating efficiencies without changing the mix of traffic it receives. For example, the foreign carrier could segregate traffic by geographic destination and terminate the traffic to two or more locations corresponding to the destination of the traffic (e.g. handing off East Coast destined traffic in New York and West Coast destined traffic in San Francisco). This type of grooming arrangement will lower the U.S. carrier's costs. And if it is offered to all U.S. carriers on a nondiscriminatory basis, it should be approved by the FCC. It provides an increase in efficiency, with no offsetting losses. How this gain will be distributed among U.S. and foreign consumers and producers, however, will depend on the extent of competition in foreign and U.S. markets.

Case 2: Grooming as a whipsawing mechanism

Another, possibly anti-consumer, reason for a U.S. carrier to participate in grooming is to increase the proportion of low-cost traffic and decrease the proportion of high-cost traffic received from the correspondent. For example, a U.S. carrier may agree to receive a reduced settlement payment in exchange for an increase in the ratio of off-peak to peak traffic that it terminates.[1] While this type of arrangement can lower one U.S. carrier's cost, it does so at the expense of other U.S. carriers who must carry a disproportionate share of the peak traffic, without receiving any increase in settlement payments. The end result could be a whipsawing of the U.S. carriers by a dominant foreign carrier in its home market, without any benefits to U.S. consumers.

Case 3: Grooming by a LEC to take advantage of above-cost access charges imposed on competitors

Finally, an Incumbent Local Exchange Carrier ("ILEC") will be in a position to negotiate a grooming arrangement that increases its share of traffic terminating to its local region,

[1]A change in the mix of traffic may not reduce peak loading uniformly on all parts of the IXC's network. International facilities may experience a different peak than the domestic facilities used to carry an international call to its final destination. Yet, it is very likely that traffic can be redistributed across different parts of the day or days of the week to reduce an IXC's costs. The grooming relationship assumed in this case would redistribute traffic among IXCs, giving the IXC with the grooming relationship a distribution of traffic that lowered its costs.

because it faces a lower cost of terminating access than the other U.S. carriers. This will be detrimental to competition and consumers in the U.S. market.

II. Artificial advantages gained by an ILEC due to its lower cost of terminating access

- Terminating access charges average about 1.5 cents/minute, which exceeds incremental cost by 1.25 cents/minute. (According to the HAI model, the cost of terminating access is approximately 0.25 cents/minute.)
- Access charges paid by the ILEC long distance operation to its local telephone arm is an internal transfer and not an actual cost to the company. The internal costs of access to the ILEC will be much lower than the tariffed access charge imposed on other U.S. long distance carriers.
- Even though there is some opportunity cost faced by the ILEC if it displaces access paid by other carriers, this does not eliminate its cost advantage. There are several reasons for this:
  - ♦ First, some of the switched access provided by the ILEC for its own long distance service will not be a substitute for its competitors' switched access, but rather for special access, in circumstances where the special access is a less efficient substitute used by the competitor only because switched access is priced above cost. There is no opportunity cost for this traffic, because the competitor was not using overpriced switched access. Yet, the ILEC gains an artificial advantage because it can substitute lower cost switched access for higher cost special access.
  - ♦ Second, the ILEC can stimulate additional terminating traffic in its region by setting a non-linear tariff (e.g. growth-based discounts), which sacrifices none of the access revenues previously sold at a high price to competitors, but sells newly stimulated traffic at a discount. This increases the ILEC's revenues and profits, and at the same time reduces its competitors' revenues and profit, because they are unable to match the deal offered by the ILEC.
  - ♦ Third, any minutes that would otherwise have been carried on a Competitive Local Exchange Carrier's ("CLEC") local loop will not have any opportunity cost associated with it. The ILEC can earn additional profits by selling these minutes at any price above its incremental cost.
- The ILEC's artificial access cost advantage will enable it to strike deals with foreign carriers that its rivals cannot match (without incurring losses). These deals will increase the ILEC's profits, and may lower prices to foreign consumers, yet it will distort competition in the U.S. market, which will be to the detriment of U.S. consumers.

III. Competitive harm from allowing grooming of in-region terminating traffic by an ILEC

- **Harm to local competition in the United States:** The ILEC may seek to carry more and more of the traffic terminating in-region as a way of closing off CLECs from a significant source of revenues. Consider the following scenario: a multi-line business customers switches some of its local lines to a CLEC. The CLEC initially receives a share of the inbound long distance traffic and access revenues (from both domestic and international traffic). The ILEC, however, negotiates with the foreign carrier to terminate a disproportionately large share of the traffic terminating in-region. The ILEC can then direct the inbound traffic onto its own local lines, circumventing the CLEC's lines serving the same customers. This will reduce the CLEC's revenues and help the ILEC maintain its monopoly of the local market. This strategy seems to be unique to the international market, where the ILEC would be able to negotiate with a single provider (i.e. the PTT) for a large amount of terminating traffic. In the domestic market, the IXCs would be far less likely to negotiate with the ILEC to hand-off all traffic terminating in region once it crosses the regional "border."

- **Harm to newly-developing competition in foreign markets:** The ILEC may use grooming deals to cooperate with a dominant foreign carrier's anticompetitive strategy against new entrants in the foreign market. For example, the ILEC could offer a growth-based terminating rate with the price for incremental minutes set <u>below</u> access charges (and thus the incremental cost of access) paid by other U.S. carriers. The ILEC could fence in this pricing deal (by using volume related provisions or other aspects of the tariff structure) to prevent other foreign carriers from benefiting these lower price. Further, the other U.S. carriers could not match these prices in their negotiations with the new foreign entrants, because they face the access charge disadvantage. Thus, the deal between the dominant foreign firm and the bottleneck monopolist in the United States would serve to foreclose competition in foreign market and deny the U.S. consumers the benefits, such as lower terminating rates, of a competitive market in the foreign country. This concern is particularly acute where foreign entrants are beginning to get a toe-hold in the market, but have not yet firmly established themselves.

- **Harm from Whipsawing:** As discussed in Case 2 above, an ILEC (like any U.S. carrier) may use grooming to harm U.S. consumers by giving the foreign carrier a lower price on some traffic (e.g. off-peak), without necessarily raising the price on other traffic (e.g. peak). This is counter to the long established anti-whipsawing protections against the market power of dominant foreign carriers. This concern is particularly acute where the foreign market is monopolized or where competition has not weakened the market power of the dominant firm.

IV. Conclusions

The anticompetitive strategies made possible by grooming arrangements between an ILEC and a dominant foreign carrier could undermine the Commissions pro-competitive domestic and international policies. Competition in most foreign markets and in the U.S. local markets is in its infancy and is particularly vulnerable to anticompetitive acts. Thus, the potential harm from grooming arrangements made by an ILEC is very large. On the other hand, the potential efficiency gains from such arrangements are very small, and the likely trickle down of these benefits to U.S. consumers even smaller or nonexistent.